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IN THE

Supreme Court of the United States

MORGAN STANLEY CAPITAL GROUP INC., *PETITIONER*,

v.

PUBLIC UTILITY DISTRICT NO. 1 OF SNOHOMISH COUNTY, WASHINGTON, *ET AL.*, *RESPONDENTS*.

CALPINE ENERGY SERVICES, L.P., *ET AL.*, *PETITIONERS*,

v.

PUBLIC UTILITY DISTRICT NO. 1 OF SNOHOMISH COUNTY, WASHINGTON, *ET AL.*, *RESPONDENTS*.

On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

BRIEF OF THE LARGE PUBLIC POWER COUNCIL AS *AMICUS CURIAE* IN SUPPORT OF RESPONDENTS

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QUESTION PRESENTED BY LARGE PUBLIC POWER COUNCIL

The Federal Power Act declares that, whenever the Federal Energy Regulatory Commission finds, upon complaint, that "any rate, charge . . . or contract" for a sale for resale of energy in interstate commerce is "unjust [or] unreasonable," it must "determine the just and reasonable rate, charge, . . . or contract" and "fix the same by order," id. § 824e(a). Did the Federal Energy Regulatory Commission ("FERC" or "Commission") err in determining that long-term market-based rate agreements formed during a period of severe spot market dysfunction are presumptively to be just and reasonable under the Federal Power Act pursuant to *United Gas Pipe Line Co. v. Mobile Gas Serv. Corp.*, 350 U.S. 332 (1956), and *FPC v. Sierra Pacific Power Co.*, 350 U.S. 348 (1956).

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INTEREST OF AMICUS[1]

The Large Public Power Council ("LPPC") is an association of twenty-four of the nation's largest municipal and state-owned utilities.[2] LPPC members provide reliable, low-cost electric service to most of the more than 40 million people served by public power. Together, LPPC members own and operate over 75,000 megawatts of generation and

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[1] Pursuant to Supreme Court Rule 37.6, counsel for *amicus* represents that no counsel for a party authored this brief in whole or in part, and that no counsel or party other than *amicus*, its members, or its counsel, made a monetary contribution intended to fund the preparation or submission of this brief. Counsel discloses that another member of the law firm in which counsel is a member represents the Nevada Attorney General, Bureau of Consumer Protection, a Respondent herein, and that Snohomish County Public Utility District is a member of LPPC, although no special assessment of costs for preparation of this brief was made to LPPC members. Pursuant to Supreme Court Rule 37.3(a), counsel for *amicus* further represents that all parties have consented to the filing of this brief. Letters reflecting this consent have been filed with the Clerk.

[2] LPPC's members joining this brief are: Austin Energy, Clark Public Utilities, Colorado Springs Utilities, CPS Energy (San Antonio), IID Energy (Imperial Irrigation District), JEA (Jacksonville, FL), Long Island Power Authority, Los Angeles Department of Water and Power, Lower Colorado River Authority, MEAG Power, Massachusetts Municipal Wholesale Electric Company, Nebraska Public Power District, New York Power Authority, Omaha Public Power District, Orlando Utilities Commission, Platte River Power Authority, Puerto Rico Electric Power Authority, Sacramento Municipal Utility District, Salt River Project, South Carolina Public Service Authority (Santee Cooper), Seattle City Light, Snohomish County Public Utility District No. 1, and Tacoma Public Utilities. Public Utility District No. 1 of Chelan County is an LPPC member but does not join this brief.

approximately 34,000 circuit miles of transmission line. LPPC members are governed by state and local laws establishing that their core obligations are to provide reliable service to native load customers at the least possible cost.

LPPC members own distribution, transmission and generating assets and generally supply substantial portions of their load through generation they own themselves. To supplement that supply, LPPC members are active in purchasing electric supply in competitive markets regulated by the Federal Energy Regulatory Commission. LPPC members have, accordingly, an avid interest in ensuring that rates in these markets are just and reasonable.

The Western energy crisis of 2000-2001 badly shook LPPC members' confidence in federally regulated competitive markets for wholesale electric service. While the FERC has taken certain steps to rectify prospectively those market conditions that FERC itself described as "dysfunctional," the Commission's refusal in the orders on review to protect customers exposed to market dysfunction serves as an ongoing warning that reliance on federal wholesale markets may be inconsistent with LPPC members' core obligations to their customers to provide least cost reliable service. LPPC's participation in this appeal reflects an effort to restore confidence in the competitive wholesale market. Consumer confidence is essential to partic pation in, and ultimately the health of, the marke for competitive power.

SUMMARY OF ARGUMENT

By FERC's own account, the Western energy crisis of 2000-2001 was the "worst in the Nation's history."[3] Just two years into the Commission's large-scale experiment with market-based rates, the West experienced "unprecedented market dysfunction."[4]

The Western energy crisis resulted from a combination of regulatory misjudgment, unique natural events, the exercise of market power and market abuse. The Commission described events contributing to the crisis as a confluence of "flawed market rules; inadequate addition of generating capacity facilities in the preceding years; a drop in available hydropower due to drought conditions; a rupture of a major pipeline supplying natural gas into California; strong growth in the economy and electricity demand; unusually high temperatures; an increase in unplanned outages of extremely old generating facilities; and market manipulation." *Californians for Renewable Energy, Inc. v. California Pub. Utils. Comm'n*, 119 FERC ¶ 61,058 at para. 30 (2007). As the Commission further commented, these actions and events conspired "to place California and the entire West in an electricity crisis that had never before been experienced." *Id.*

At the height of this crisis, in sometimes desperate efforts to ameliorate the exposure of their customers to these markets, wholesale customers, including LPPC members, sought what they hoped would be the

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[3] Brief of the Federal Energy Regulatory Commission In Opposition to Certiorari at 22, filed in these proceedings on August 6, 2007 ("FERC Br.")

[4] *Id.* at 13.

relatively safe harbors of long-term electric supply agreements. As FERC Commissioner Massey noted in his dissent below, FERC encouraged customers to enter into these contracts, and "assured buyers that they would be protected from the exercise of market power." Further, Commissioner Massey noted that the Commission "set a $74 Mwh benchmark" which it said it "would expect to use in assessing any complaints regarding the justness and reasonableness of pricing such long-term contracts negotiated under current market conditions." JA 1308a (citing 93 FERC para 91,294 at 61,982 (2000)).

Thus, it is quite clear that dysfunction in FERC-administered spot market had a dramatic adverse impact on prices available to these customers in long-term forward markets. FERC's Staff so concluded in its "Final Report on Price Manipulation in Western Markets," issued on March 3, 2003 in Docket No. PA02-2-000 ("Staff Report"). JA 209sa. And while prices in the spot market eventually responded favorably to the Commission's ministrations (thereby revealing the extent of the dysfunction), prices set in long-term agreements have continued to reflect the impact of the dysfunctional market during the 2000-2001 energy crisis.

In the orders on review, the Commission expressly stated the finding that the spot market at the time the contracts at issue were negotiated was "dysfunctional" and that the rates for sales of power in the short-term spot market were "unjust and unreasonable," as that term is understood in the Federal Power Act ("FPA"). JA 1222a – 1299a at JA 1275a; JA 1554a. Further, the Commission acknowledged the conclusion of its Staff Report that

spot market distortions flowed through to forward power prices, and thus directly affected contracts entered into for future delivery.

Nevertheless, the Commission went on to hold that such evidence was not "relevant" under the "public interest" standard applicable to the agreements under the *Mobile-Sierra* doctrine.[5] According to the Commission, "[a] finding that unjust and unreasonable spot market prices caused forward market prices to be unjust and unreasonable would be relevant to contract modification only where there is a 'just an reasonable' standard of review." JA 1275a-JA 1276a. "Under the 'public interest standard,'" FERC held, "to justify contract modification it is not enough to show that forward prices became unjust and unreasonable due to the impact of spot market dysfunctions; it must be shown that the rates, terms and conditions are contrary to the public interest." *Id.* Rates under the agreements were instead presumed to be just and reasonable.

The Commission's decision to presume under the *Mobile-Sierra* doctrine that contract rates entered into during this period of acknowledged market dysfunction are just and reasonable is clear error. While the courts have agreed with the Commission that competitive forces may be relied on to achieve just and reasonable rates,[6] it is axiomatic that when

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[5] The *Mobile Sierra* doctrine refers to this Court's companion decisions in *United Gas Pipe Line Co. v. Mobile Gas Service Corp.*, 350 U.S. 332 (1956) ("*Mobile*"), and *FPC v. Sierra Pacific Power Co.*, 350 U.S. 348 (1956) ("*Sierra*") (together, "*Mobile-Sierra*")

[6] *See Farmers Union Cent. Exch., Inc. v. FERC*, 734 F.2d 1486, 1501-09 (D.C. Cir. 1984); *Elizabethtown Gas Co. v. FERC*, 10 F.

such markets break down, the rates they produce cannot be presumed to be just and reasonable, as the Commission decisions on review concede. When that happens – when markets become dysfunctional (to use the Commission's own description) – it is wrong to conclude that rates in contracts entered into in such a period can be presumed to be just and reasonable.

Side-stepping the issue of just and reasonable rates, the Commission, other Petitioners, and supporting *Amici*, have made much of the potential adverse impact that reversal of the Commission may have on the climate for investment.[7] Yet, the circumstances presented on appeal in which contracts would be subject to review under a just and reasonable standard are narrowly confined to those in which the agency has itself determined that markets are dysfunctional. In its brief opposing *certiorari*, referencing reforms which FERC says will help it ensure that markets function properly, FERC itself commented that these circumstances are unique and unlikely to be repeated.

Moreover, to the extent the investment climate is taken into account, LPPC also urges the Court to weigh the impact on the marketplace of a decision frustrating consumers' legitimate expectation of regulatory protection from dysfunctional markets. While FERC has recently taken steps to police competitive markets prospectively, the assurance that adequate remedies are available when markets go

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3d 866 (D.C. Cir. 1993); *California ex rel. Lockyer v. FERC*, 383 F.3d 1006, 1009 (9th Cir. 2004), *cert. denied*, 127 S. Ct. 2972 (2007) ("*Lockyer*").

[7] *See infra* note 18.

awry provides confidence in market outcomes. Consumer confidence in the market is as important a factor as investor confidence in creating a sound market structure and, ultimately, a firm basis for investment. Consumer confidence has been badly shaken,[8] and without it, those consumers who can will vote with their feet. Surely, the climate for competitive investment cannot be benefited by this.

Ultimately, the Court must direct the Commission to comply with its governing statute. FPA section 205(a) stipulates that "[a]ll rates and charges made, demanded, or received by any public utility for or in connection with....the sale of electric energy subject to the jurisdiction of the Commission....shall be just and reasonable, and any such rate or charge that is not just and reasonable is hereby declared unlawful." 16 U.S.C.A. § 824d(a). In a dysfunctional market, adopting a presumption that contract prices affected by such dysfunction are just and reasonable conflicts with the agency's statutory responsibility and common sense.

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[8] *See Public Power*, Volume 56, No. 3, "The False Promise of Restructuring." *See* David Cay Johnston, "A New Push to Regulate Power Costs, " N.Y. Times, Sept. 4. 2007, at C1. *See* David Cay Johnston, "Competitive Priced Electricity Costs More, Studies Show," N.Y. Times, Nov. 6, 2007, at C4, corrected Nov. 15, 2007.

ARGUMENT

I. MARKET-BASED RATE AGREEMENTS FORMED DURING A PERIOD OF MARKET DYSFUNCTION CANNOT BE PRESUMED TO BE JUST AND REASONABLE UNDER THE *MOBILE-SIERRA* DOCTRINE.

A. The Ninth Circuit is Right that a Functional Market is an Essential Prerequisite for Application of the *Mobile-Sierra* Presumption that Contract Rates are Just and Reasonable in a Market-Based Rate Setting.

FERC and Petitioners are wrong to attack the Ninth Circuit for establishing what are said to be unprecedented "prerequisites" to application of the *Mobile-Sierra* doctrine.[9] While the Court in *Mobile* and *Sierra* did not speak of conditions or "prerequisites" to the application of the doctrine, those decisions addressed the question whether rates were just and reasonable in the context of a tightly regulated, cost-based rate regime. In that historical setting, with the regulated, cost-based rate serving as recourse for both buyer and seller, it is entirely reasonable to *presume* that rates and terms derived by mutual agreement of the parties are just and reasonable, absent a significant showing why it would be otherwise. By contrast, in a market-based rate

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[9] FERC Br. at 25-26; Brief of Calpine Energy Services, L.P., *et al.*, at 48-52 ("Calpine Br.").

setting, there is no basis for a presumption that negotiated rates are just and reasonable *unless* there is reasonable assurance that the market is functioning appropriately.

In cases subsequent to *Mobile* and *Sierra*, in which more novel terms and conditions of service have been at issue, with judicial blessing, FERC has in fact been more jealous of its initial prerogative to review agreements *ab initio*, and not simply to allow parties the benefit of a presumption that their bargain is in the public interest without substantive review. *See*, e.g., *Maine Public Utils Comm'n v. FERC*, 454 F.3d 278, 283 (D.C. Cir. 2006), in which the court comments that the *Mobile-Sierra* presumption has no place when a contract (in that case, regarding formation of a Regional Transmission Organization) is submitted to FERC for the first time. *See also Potomac Elec. Power Co. v. FERC*, to 210 F. 3d 403, 409 (D.C. Cir. 2000) (applying the doctrine in "first review cases would mean that [the agency's] ability to protect the public interest would be negligible and public regulation would consist of little more than rubber-stamping private contracts." (quoting *Northeast Utils. Serv. Co.*, 66 FERC ¶ 61,332 at p. 62,087 (1994)). Further, the courts have been clear that that the *Mobile-Sierra* presumption applies only so long as "there is no reason to question what transpired at the contract formation stage." *See e.g., Atlantic City Elec. Co. v FERC*, 295 F.3d 1, 14 (D.C. Cir. 2002); *Town of Norwood v. FERC*, 587 F. 2d 1306, 1312 (D.C. Cir. 1978).

On Brief, FERC now eschews the need to review what at transpired at the contract formation stage, and disputes its practicality, asserting that its order

granting a utility market-based rate authority provides blanket approval of rates under contracts entered into subsequently. 103 FERC ¶ 61,353 at para. 37. JA 1246a. FERC asserts that a requirement to approve each agreement would fundamentally conflict with the market-based rate framework. *Id.* While LPPC does not disagree that blanket approval for market-based agreements may be provided, the ensuing presumption that contract rates are just and reasonable can only attach if the market place in which these agreements are executed is functional.

In its Brief in Opposition to *certiorari* at 24, FERC observed that neither this Court, nor any other, has had reason to consider the application of the *Mobile-Sierra* doctrine in the context of a market-based rate regime. Addressing petitioners seeking *certiorari*, FERC commented that none of the cases applying *Mobile-Sierra* "concerned a market-based contract, much less one entered into during the Nation's worst power crisis." *Id.*

Stepping into the breach, the Ninth Circuit concluded that the Commission's blanket approval of market-based rate contracts would be an acceptable predicate for invoking the *Mobile-Sierra* presumption if (1) procedures had been put in place for timely reconsideration of market-based rate authority when warranted; and (2) consideration is given to the market conditions at issue when contracts are formed.[10]

Put slightly differently, the Ninth Circuit correctly held that in view of the fluid operation of the marketplace, the Commission must assure on a

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[10] Pet. App. 38a, 46a, 56a - 58a.

current basis that market-based rates continue to be just and reasonable if contracts entered into under this regime are to enjoy a presumption that they meet the statutory standard. FERC itself acknowledges that the circumstances at the time a seller is granted market-based rate authority can change unpredictably. FERC Br. At 34. Without the assurance that markets are not dysfunctional at the time contracting parties enter into their agreements, it simply cannot be presumed that the agreements are just and reasonable. If, as the Commission concedes was the case here, markets at the time of contract formulation were dysfunctional, customers must be permitted an opportunity to prove that their agreements are unjust and unreasonable.

The Ninth Circuit's approach reasonably delivers on the statutory assurance that rates will be just and reasonable in a market-based rate setting, while honoring the *Mobile-Sierra* presumption favoring freely negotiated contracts.[11] While courts considering the question have generally agreed that the just and reasonable standard may be met by reliance on a market-based rate regime, the decisions have been equally clear that this regime carries with it an obligation on FERC's part to provide the ongoing assurance that the conditions justifying market-based rates will continue to be met. In, e.g., *Elizabethtown Gas Co. v. FERC*, 10 F.3d 866 (D.C. Cir. 1993), while satisfied that the Commission had demonstrated

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[11] FPA section 205(a) stipulates that "[a]ll rates and charges made, demanded, or received by any public utility for or in connection with....the sale of electric energy subject to the jurisdiction of the Commission....shall be just and reasonable...." 16 U.S.C.A. § 824d (2005).

initially that the applicants' markets were "sufficiently competitive to preclude it from exercising significant market power," the court further relied on FERC's guarantee that "it will exercise its [Natural Gas Act] § 5 authority (upon its own motion or upon that of a complainant) to assure that a market...rate is just and reasonable." *Id. at* 870. In *Farmers Union Cent. Exch. Inc. v. FERC*, 734 F.2d 1486 (D.C. Cir. 1984), while positing the potential for market forces to bring rates within a just and reasonable level, the court faulted the Commission for its "largely undocumented reliance on market forces." *Id.* at 1508.

Similarly, in *California ex rel. Lockyer v. FERC*, 383 F.3d 1006, 1014 (9th Cir. 2004), *cert. denied,* 127 S. Ct. 2972 (2007) ("*Lockyer*"), while upholding the Commission's reliance on market forces in order to establish just and reasonable rates, the court faulted the Commission for failing to administer its quarterly reporting requirement, a mechanism that the court concluded would have enabled the Commission to ensure that the statutory standard is met, thereby avoiding the charge that it effectively deregulated prices, in violation of the statutory requirement that rates be filed and continue to be just and reasonable. As the court in *Lockyer* pointed out, in failing to provide a mechanism for monitoring and remedying prices where needed, the Commission had effectively deregulated prices administratively, in contravention of the statute and this Court's decisions in *MCI Telecomm. Corp. v. AT&T,* 512 U.S. 218 (1994) and *Maislin Indus. US v. Primary Steel, Inc.*, 497 U.S. 116 (1990). *Id.* at 1014.

The Commission is capable, as it states, of remedying dysfunctional markets on a prospective basis. But, as FERC itself observes, market dysfunction may arise after the execution of a contract and can occur unpredictably. FERC Br. at 34. Thus, unless a functioning market is held to be a predicate for application of the *Mobile-Sierra* presumption, the promise of prospective correction essentially cuts adrift from statutory protection those customers who have entered into long-term agreements. This is a poor result as a matter of policy, because it discourages parties from entering into long-term agreements.[12] As a matter of law, it violates the assurance in FPA section 205(a) that "[a]ll rates and charges made, demanded, or received by any public utility for or in connection with....the sale of electric energy subject to the jurisdiction of the Commission....shall be just and reasonable, and any such rate or charge that is not just and reasonable is hereby declared unlawful." 16 U.S.C.A. § 824d.

B. Market-Based Rate Contracts Formed During a Period of Market Dysfunction Cannot Be Presumed to be Just and Reasonable.

"The California ISO and PX spot markets," FERC stated below, "were dysfunctional during the relevant period" and "the rates in those markets were unjust and unreasonable. JA 1275a. FERC further acknowledged that its Staff Report concluded that spot market distortions flowed through to forward

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[12] This point was made by dissenting Commissioner Massey. *See* JA 1308a – 1309a.

power prices, and to contracts entered into for future delivery. JA 1275a. And during this same period FERC made two commonsense observations about the relationship between the spot markets and prices in the long term markets. "Maintaining an accurately priced spot market," it said in *AEP Power Mktg., Inc.*, 97 FERC ¶ 61,219 at 61,972 (2000), is the single most important element for disciplining longer term transactions." "Higher spot market prices," it also observed, "in turn affect the prices in forward markets." *San Diego Gas & Elec. Co. v Sellers of Elec. and Ancillary Servs.*, 93 FERC ¶ 61,121 at 61,367 (2000).

The Commission nevertheless held that, under the *Mobile-Sierra* doctrine, none of this was relevant to the question whether to modify contracts entered into during this period. Denying even the need to ascertain whether its Staff was right in determining that spot market distortions affected prices in forward contracts, or the conclusion that the markets were subject to market manipulation and gaming, the Commission held:

> [E]ven if we were to assume that these allegations and/or findings were true, they would not be determinative of the issues in the instant proceeding. *The Commission has already concluded that the California ISO and PX spot markets were dysfunctional during the relevant period and that rates in those markets were unjust and unreasonable.*[13]

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[13] Citing *San Diego Gas & Elec. Co. v. Sellers of Energy & Ancillary Servs.*, 93 FERC ¶ 61,121 at pp. 61,359-60, 72 (2000), *order on reh'g and clarification*, 97 FERC ¶ 61,275 at p. 62,225 (2002).

> Evidence of market manipulation merely suggests another cause of the spot market dysfunctions and the unjust and unreasonable rates in the spot markets. *However, a finding that unjust and unreasonable spot market prices caused forward bilateral prices to be unjust and unreasonable would be relevant to contract modification only where there is a "just and reasonable" standard of review*....As we have previously concluded, the contracts at issue in this proceeding do not have such a standard but rather evidence an intent that the contract may be changed only pursuant to the "public interest" standard of review."[14]

JA 1274a - 1275a (emphasis added).

Putting aside the fact that there is only one standard of review – a just and reasonable standard – FERC's orders squarely present the question whether a presumption that contractual rates are just and reasonable attaches to contracts executed under a market-based rate regime regardless of whether FERC itself has concluded that markets at the time of contract formation are dysfunctional.

LPPC urges the Court to conclude resoundingly that the answer is "no." While the Commission has determined, and the courts have agreed, that

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[14] The Commission later determined that these markets were subject to gaming and manipulation. *See Enron Power Mktg., Inc.*, 106 FERC ¶ 61,024 at paras. 26, 29 (2004). Further, the Commission required refunds of sellers in the spot market in order to constrain rates to just and reasonable levels for the period precisely coincident with the formation of the contracts here at issue. *See San Diego Gas & Elec. Co.*, 96 FERC ¶ 61,120 (2001).

competitive forces may be relied on to achieve just and reasonable rates,[15] the rates they produce cannot be just and reasonable if the markets break down, as the decisions on review concede. When that happens – when markets become dysfunctional (to use the Commission's own description) – it is wrong to conclude that rates in contracts entered into in such a period can be presumed, much less conclusively presumed to be just and reasonable.

The Commission's decision to ignore the necessity of a just and reasonable backstop before presuming that negotiated agreements meet the statutory standard stands in marked contrast to its earlier conclusion that, in circumstances where market-based rates cannot be justified, utilities may be permitted to charge individually negotiated rate agreements only where viable cost of service recourse service is available. *Alternatives to Traditional Cost-of-Service Ratemaking for Natural Gas Pipelines*, 74 FERC ¶ 61,076 at 61,240 (1996), clarified, 74 FERC ¶ 61,194 (1996), *order on reh'g*, 75 FERC ¶ 61,024 (1996) (emphasis added). There, the Commission commented that it was

> ...particularly concerned about maintaining the integrity of the recourse service. In order to be successful, the recourse service must remain a viable alternative to negotiated service. Otherwise, if the recourse service remains stagnant, in time, the recourse service will become outmoded and

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[15] *See Farmers Union Central Exch., Inc. v. FERC*, 734 F.2d 1486, 1501-09 (D.C. Cir. 1984); *Elizabethtown Gas Co. v. FERC*, 10 F. 3d 866 (D.C. Cir. 1993); *California ex rel. Lockyer v. FERC*, 383 F.3d 1006, 1009 (9th Cir. 2004), *cert. denied*, 127 S. Ct. 2972 (2007) ("*Lockyer*").

> will cease to be a viable alternative to negotiated service. Since the purpose of the recourse service is to act as a check against pipeline market power, such a result is impermissible.

74 FERC ¶ 61,076 at 61,240 (emphasis added).

The competitive market may provide similar recourse for customers in a market-based setting *if the market functions correctly,* a matter that the Court in *Mobile-Sierra* had no reason to consider. It would be reasonable to conclude, as urged by the Commission and supporting Petitioners, that parties may be held to the benefits and burdens of agreements freely executed in a competitive market. However, where the competitive market does *not* exist – i.e., where the market is dysfunctional and the Commission itself holds that the market has broken down -- customers have no such backstop and there is no assurance that the rate agreements customers may be required to enter into are just and reasonable.

Put slightly differently, without giving customers recourse to a rate the Commission can determine to be just and reasonable, there is no possible way for the Commission to provide the assurance required under the FPA that all rates will be just and reasonable. FPA section 205(a) states that "[a]ll rates and charges made, demanded, or received by any public utility for or in connection with....the sale of electric energy subject to the jurisdiction of the Commission....shall be just and reasonable, and any such rate or charge that is not just and reasonable is hereby declared unlawful." 16 U.S.C.A. § 824d(a) (2005).

In his dissenting opinion below, FERC Commissioner Massey made precisely this point, commenting that

> [t]he tainted atmosphere in which these contracts were negotiated was unprecedented and extraordinary. The most influential benchmark used in negotiating forward contacts – the spot market and expectations of future spot prices – was wildly dysfunctional. When these contracts were negotiated, the Commission had already declared that conditions in the California markets allowed the exercise of market power and rates were unjust and unreasonable....Those market conditions certainly tainted any contracts negotiated during this time frame. It would simply defy logic to conclude that the high prices in these contracts were not adversely influenced by market conditions that included the exercise of market power and wide spread market manipulation.

JA 1317a – JA 1318a.

The Commission's earlier conclusion that effective recourse service is an essential check on pipeline market power (and the threat to just and reasonable rates) also serves to rebut Petitioners who have argued that the Commission and the Court have no reason to intervene in what amounts to a commercial dispute among "sophisticated" parties well-aware of the risks they took when entering into the relevant agreements.[16] To the same effect, FERC argues:

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[16] *See, e.g.*, Brief for Petitioner Morgan Stanley Capital Group at 12- 14, 31 – 32 ("MSCG Br.").

> Once dysfunction in the spot market occurred, it was inevitable that it would impose costs on someone. The parties to these contracts presumptively had equal access to information about the functioning of the spot markets, and they made a knowing and intelligent choice about how to allocate risks and costs. Had the purchasers believed that the rates in their contracts might become unjust and unreasonable...they could have insisted on a clause preserving their right to seek Commission modification of the contracts.

FERC Br. at 45.

But it may only be assumed that customers have bargaining power equal to their utility suppliers when customers are operating with an effective safety net assuring that they have recourse to just and reasonable rates. While market-based spot market rates may supply such a safety net, dysfunction in the market undermines that protection. With the Commission's concession that just and reasonable rates were unavailable to customers as of the time they entered into the agreements at issue, the decision to apply a presumption that the resulting rates are just and reasonable is directly at odds with the FPA.

In this connection, it is particularly jarring that Petitioners argue that the Court should adjudge utility customers' rights in this case just as it would any counterparties to a commercial agreement.[17] But

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[17] At 34, Morgan Stanley invokes Uniform Commercial Code provisions stipulating that market fluctuations "are exactly the type of business risk which business contracts made at fixed

the unqualified presumption that buyers of wholesale power have bargaining strength equal to that of regulated sellers has no grounding in the statute.[18] The FPA establishes an entirely different framework for determining the parties' rights than does an unregulated commercial setting. It reflects "a reasonable accommodation between the conflicting interests of contract stability on the one hand and public regulation on the other." *Mobile, supra*, 350 U.S. at 344. To use FERC's own words, [t]he fact that [utilities] can dictate the terms of their contracts entered into with their customers forms at least one of the premises for regulation." *Tenneco Oil Co.*, 26 FERC ¶ 61,030 at 61,069 (1984). And while market forces may play a role in satisfying the statutory requirement that rates be just and reasonable, the Commission abdicates its statutory responsibility in simply entrusting customer welfare to the marketplace without a determination that the market is capable of ensuring just and reasonable rates. *MCI Telecomm. Corp. v. AT&T, supra; Maislin Indus. US v. Primary Steel, Inc., supra.* In the circumstances in this case, with the Commission's own determination that rates in the market are unjust and unreasonable,

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prices are intended to cover [citing U.C.C. § 2-615(a)]."

[18] Citing dicta in this Court's decision in *Verizon Communications, Inc. v. FCC*, 535 U. S. 467, 479 (2002), Petitioners assert that buyers and sellers of wholesale electricity have presumptively equal bargaining power. MSCG Br. at 30-31; Calpine Br. at 34, 39; FERC Br. at 22, 34. But the statutory presumption is exactly the opposite. The parallel provisions of the Natural Gas Act, for example, were enacted to regulate "monopolistic forces" controlling the sale of natural gas. *FPC v. Texaco, Inc.* 417 U.S. 380, 397-98 (1974).

it simply cannot presume that the resulting contracts satisfy the statutory standard.

It does not help Petitioners to argue that the term "market dysfunction" has no defined meaning and therefore lacks significance on appeal. *See* Brief of William Baumol, *et al.* as *Amici Curiae* in Support of Petitioners at 21, *et seq.* ("Market 'dysfunction' is particularly pernicious basis for abrogation because it has no well-defined meaning.")("Baumol Br."). In fact, the orders on review make clear that the Commission very well understood the import of its conclusion that markets in the relevant period were dysfunctional; it meant that rates did not meet the statutory just and reasonable standard. The Commission expressly "*concluded that the California ISO and PX spot markets were dysfunctional during the relevant period and that rates in those markets were unjust and unreasonable.*" JA 1275a. With that, the Commission's determination that the market in all relevant periods was dysfunctional meant that rates were unlawful during this period. For purposes of the issues on appeal, that is all the Court needs to know.

II. Petitioner's Concern Over the Impact of Contract Modification on the Investment Climate are Overstated and, In Any Event, No Basis for Refusing to Remedy Unlawful Rates.

The nearly hysterical tone of Petitioners and *amici* on the impact on the investment climate of a decision removing the *Mobile-Sierra* presumption in this case belies the limited circumstances in which contracts

may indeed be reopened.[19] In its brief opposing *certiorari* in this case at 12, FERC commented that the Ninth Circuit's decision was confined to the "narrow proposition that, if there is a credible claim that severe market dysfunction has affected the formation of a market-based rate contract, the Commission must take that fact into account...." In fact, even more narrowly, a decision reversing the Commission would stand for the limited proposition that where markets are dysfunctional, and cannot constrain rates to just and reasonable levels, it may not be presumed that contracts entered into for that period are just and reasonable. And even then, upon examination, the Commission may very well hold that the contracts indeed meet the statutory standard.

It bears no small emphasis that contracting parties have never been shielded from the risk of Commission-ordered contract modification, even under a "public interest standard." As FERC has stated:

> [W]e have the authority under the public interest standard to modify a contract where: it may be unjust, unreasonable, unduly discriminatory or preferential to the detriment of purchasers that are not parties to the contract; *it is not the result of arm's-length bargaining; or it reflects circumstances where the seller has exercised market power over the purchaser.*

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[19] *See* Calpine Br. at 36-42. *See* MSCG Br. at 36-40. *See* Baumo Br. at 15-18, 24-25.

Northeast Utils. Serv. Co., 66 FERC ¶ 61,332 at 62,078 (1994), *aff'd, Northeast Utils. Serv. Co. v. FERC*, 55 F.3d 686 (1st Cir. 1995)(emphasis added).

As the Commission observed in its brief at 12, prior to its change of heart:

> Taken as a whole, the decisions of the court of appeals allow the Commission sufficient discretion on remand to consider all relevant factors in determining whether the contracts at issue should be upheld or reformed. Allowing the Commission to address these issues will not "cause severe damage to the wholesale energy markets." 06-1457 Pet. 25. The decisions have not, as petitioners suggest caused a flood of complaints by disgruntled purchasers seeking to reform contracts. In fact, there have been relatively few complaints, and, more important, the Commission promptly rejected those that lack merit.

Equally to the point in considering the impact of the decision on review is the importance of consumer confidence in the competitive wholesale marketplace in creating a sound market structure and a firm basis for investment. LPPC members will attest that the Western energy crisis of 2000-2001 badly shook that confidence. Without it, those consumers who can will vote with their feet in order to avoid FERC-regulated markets. Municipalities will learn not to trust the marketplace for their supply, and states will direct utilities to withdraw from participation in the

competitive market.[20] Surely, the climate for competitive investment cannot be benefited by this.

In the final analysis, the Court must direct the Commission to do what the statute requires. In a dysfunctional market, adopting a presumption that contracts customers are forced to enter into are just and reasonable conflicts with common sense and the agency's statutory responsibility. The Commission must be reversed.

III. *CHEVRON* IS INAPPLICABLE WHERE, AS HERE, THE AGENCY'S DECISION IS BASED, NOT ON ITS INTERPRETATION OF THE STATUTE IT ADMINISTERS, BUT ON A MISTAKEN INTERPRETATION OF THIS COURT'S PRECEDENTS.

FERC maintains (Br., p. 20 · 21) that its decision is entitled to deference under this Court's decision in *Chevron USA v. Natural Res. Defense Council*, 467 U.S. 837 (1984). This Court can quickly dispose of

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[20] The proposition that the public interest is not disadvantaged as long as high rates do not cripple buyers who executed the contracts at issue is also at variance with this Court's observation that "[i]n the context of ratemaking, it is typically the case that any increment in the rate will only make a small dent in the consumer's pocket," but that the statutory requirement to establish just and reasonable rates "reflects a congressional determination that potential savings for consumers as a class are important even though rate changes will generally not have any great economic significance for any individual consumer." *American Paper Inst. v. American Elec. Power*, 461 U. S. 402, 417 n. 11 (1983)(quoting *FPC v. Texaco, Inc., supra*, 417 U.S. at 399).

that claim. Under *Chevron*, this Court will defer to an agency's reasonable interpretation of an ambiguous statute it is charged to administer. *Id.* at 2782.

But FERC states repeatedly that its decision was compelled by *this Court's decisions* in *Mobile* and *Sierra*, not by *its* interpretation of an ambiguity in the Federal Power Act. JA 1225a-1226a, JA 1229a, JA 1243a-JA 1245a; *See* JA 1229a (decision "*dictated* by the Supreme Court under the *Mobile-Sierra* doctrine.") This Court owes no deference to FERC when the agency's reasoning is based upon what it believes it is obligated to do by previous court decisions rather than by its interpretation of an ambiguity in the statute itself. *See, e.g., Phillips Petroleum Co. v. FERC*, 792 F.2d 1165, 1169 (D.C. Cir. 1986); (*Chevron* is inapplicable where FERC "did not exercise its own judgment" but believed itself bound by the Supreme court's decision."); *New England Motor Rate Bureau, Inc. v. Fed. Trade Comm'n*, 908 F.2d 1064, 1071-72 (1st Cir. 1990); *Prill v. NLRB*, 755 F.2d 941, 947-50 (D.C. Cir. 1985), *cert. denied, Meyers Indus., Inc. v. Prill*, 474 U.S. 948 (1985).

CONCLUSION

For reasons articulated above, the Court should affirm the judgment of the Court of Appeals.

Respectfully submitted,

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